Introduction to

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May Half-Year Conference

Riga, 17-20 May 2017

Financing Strategies for Start-ups: How to fund your business idea – an Overview

Riga, 18 May 2017, Half-Year Conference

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Table of Contents

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Financing Strategies

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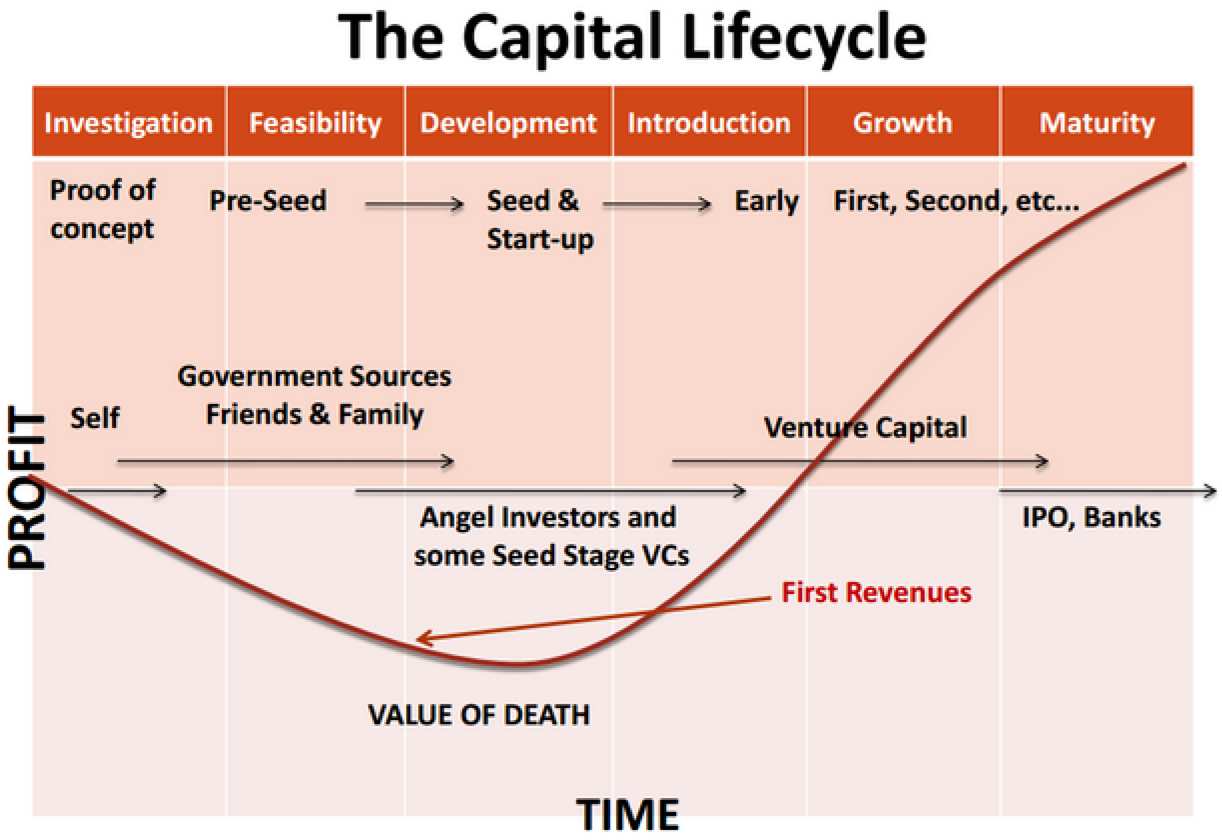
Funding Life Cycle of Startups



Source: http://www.ibusinessangel.com/2012/07/how-soon-should-business-angels-get-involved-with-startup-businesses/

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Relevance of Raising Outside Capital

Why raise Outside Capital?

- Technological progress “prohibits” slow growth
- Time to market is crucial
- Founders vs. patron culture has changed

➡ Underpinning of today’s thriving venture capital industry

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Raising Outside Capital: From Whom?

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Raising Outside Capital

From whom: What type of investors are out there?

3Fs

(~ EUR 50k – 200k)

Crowd?

Business Angels

(~ EUR 50k – 500k)

Strategic Investors (CVCs)

(*varies a lot*)

Financial Investors (VCs)

(~ EUR 1m – 10m)

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Raising Outside Capital: How?

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How: What forms of financings are available in practice? (1/9)

Pre-Seed and Seed-stage

- Non-dilutive grants (public initiatives, business plan competitions etc.)
- (Convertible) loans from 3Fs and angels
- Common equity financing from 3Fs and angels
- Preferred equity financing from seed-stage VCs/CVCs (and sometimes angels)

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How: What forms of financings are available in practice? (2/9)

Growth-stage (Series A, B, C etc.)

- Preferred equity financing from VCs/CVCs (and sometimes angels)
- Convertible (bridge) loans from VCs/CVCs
- Common equity financings from CVCs?

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How: What forms of financings are available in practice? (3/9)

Convertible Loans

- Concept
  - (Straight) loan from investors to the startup (debt liability on the balance sheet)
  - Usually interest-bearing (accruing), often ranging between 5 and 10%
  - Fixed term (usually until the next financing round with a cushion, i.e. 6 – 18 months, in rare cases more)

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How: What forms of financings are available in practice? (4/9)

Convertible Loans

- Concept (cont'd)
  - Conversion (usually mandatory) of loans together with accrued interest into shares of the startup on the occasion of the next (qualified) equity financing round prior to the loan's maturity date
  - Conversion usually with a discount on the share price ranging from 0 – 25%
  - Depending on local jurisdiction: Subordination

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How: What forms of financings are available in practice? (5/9)

Convertible Loans

- Strategic Considerations
  - Easy to set up (no share issuance involved, usually no registration requirements)
  - Cheaper than an equity financing round
  - Allows to postpone the discussion about the valuation of the company (main driver for convertible loans in seed-stage financings)
  - Immediate cash with no subsequent cash out until a possible repayment
  - No dilutive effect until conversion
  - Will increase the number of preferred shares

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How: What forms of financings are available in practice? (6/9)

Common/preferred equity financings

- What are common shares, what are preferred shares?
  - Common shares are shares that are typically subscribed by the founders and possibly the first pre-seed/seed investors
  - Preferred shares are (usually) a separate class of shares that have superior rights and preferences over the common shares

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How: What forms of financings are available in practice? (7/9)

Common/preferred equity financings

- Typical rights and preferences of preferred shares
  - Liquidation preferences (participating / non participating)
  - Dividend preferences (cumulative / non-cumulative)
  - Subscription preferences
  - Anti-dilution protection in case of down rounds (full ratchet/weighted average)

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How: What forms of financings are available in practice? (8/9)

Common/preferred equity financings

- Typical rights and preferences of preferred shares (cont’d)
  - Protective provisions (veto rights and qualified majority requirements)
  - Board seat entitlements
  - Information rights
  - Drag-/tag along preferences

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How: What forms of financings are available in practice? (9/9)

Common/preferred equity financings

- Strategic considerations
  - Equity financings are more complex (valuation, share issuance, shareholders' agreement, registration requirements etc.) and, therefore, more costly (EUR 10-50k legal fees plus legal fees of lead investor of usually between EUR 20k and 50k)
  - Dilutive financing
  - Sets a benchmark in terms of valuation
  - Liquidation preferences create path dependencies for future financing rounds (waterfall considerations)

Raising Outside Capital: How much?

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How much should startups aim to raise? (1/3)

Strategic Considerations

- Valuations are based on calculations of risk and reward
- Valuation will not just increase linearly over time from financing round to financing round
- In practice, risk is reduced in increments when particular milestones are reached
- Once a startup has achieved the right product/market fit and implemented a scalable sales model, it will usually start to see its valuation increase linearly as a multiple of revenues or profitability

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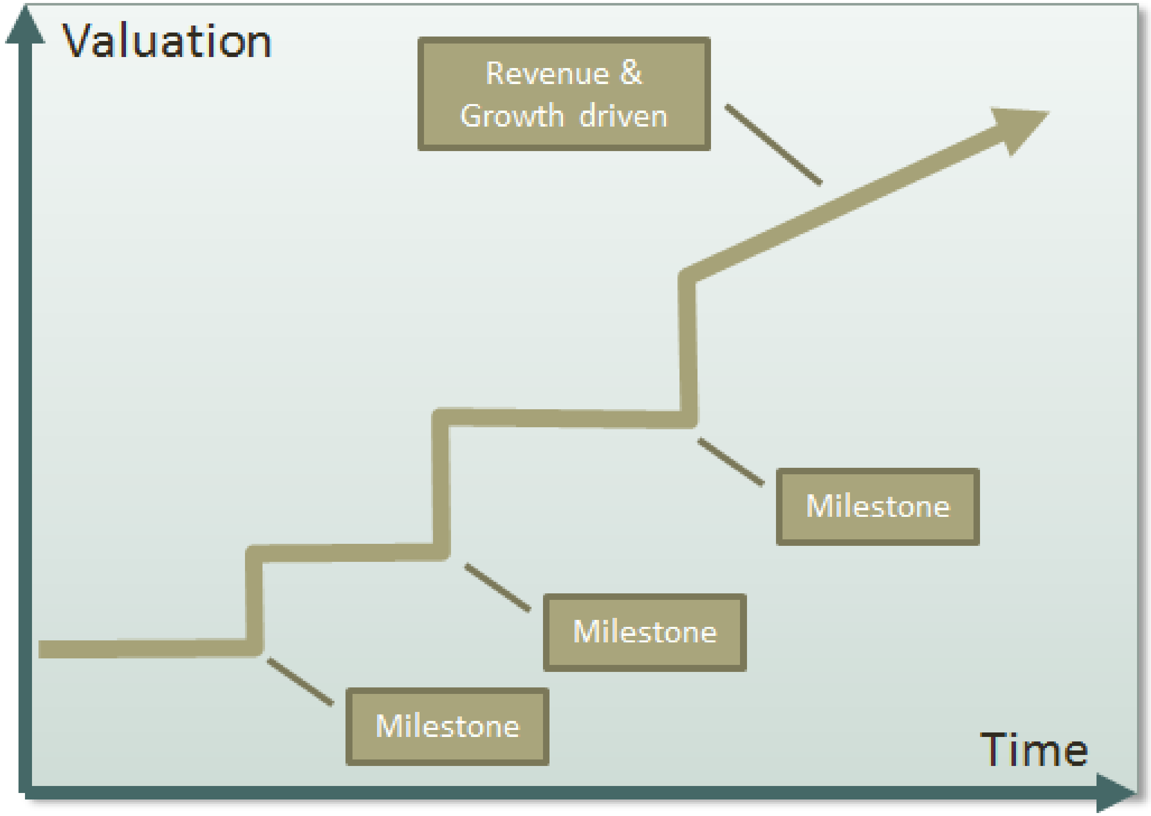
How much should startups aim to raise? (2/3)

Preliminary Considerations (cont'd)

- Milestones could be:
  - proof of concept
  - prototype
  - completion of beta testing
  - customer traction
  - hiring of key employees/management
  - regulatory clearances
  - break-even
  - etc.



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How much should startups aim to raise? (3/3)

Main Considerations

- The more capital you raise, the more diluted you get
- Startups should aim to raise as much capital as necessary to get to the next major milestone that will justify a substantive increase in the startup's valuation
- Obviously, a startup should include some cushions in order to account for unexpected events (20-40% is not uncommon)

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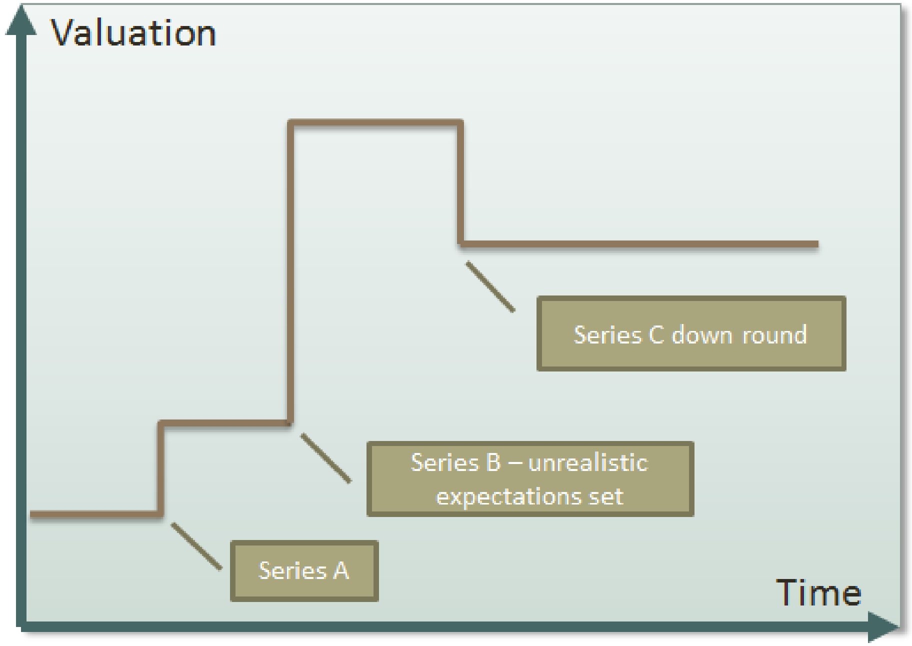
Raising Outside Capital: At which valuation?

At which valuation: What is the right "price"? (1/5)

Preliminary Considerations:

- **Up-round** = Pre-money valuation is **higher** than the post-money valuation of the last financing round
- **Down-round** = Pre-money valuation is **lower** than the post-money valuation of the last financing round
  > triggers anti-dilution protection of existing investors!



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At which valuation: What is the right “price”? (2/5)

Strategic Considerations

- Reasons for avoiding a low valuation are self-evident (dilution, reputation etc.)
- Achieving a too high valuation, however, can become a real burden
- Valuations that are negotiated with outside investors increase market trust in the startup -> serial funding through VCs…

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At which valuation: What is the right “price”? (3/5)

Strategic Considerations (cont’d)

- Beware of the option pool: An option pool (ESOP) is nothing more than shares set aside for future employees (usually somewhere between 10-20%) -> Investors usually invest on a fully-diluted basis, meaning that the future shares are already factored in for the valuation of the company resulting in a lower share price
- It is perceived to be a common mistake of founders to focus too heavily on avoiding dilution (that comes with a lower valuation) by raising less money

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At which valuation: What is the right “price”? (4/5)

Early-stage valuation

- Early stage valuation is commonly described as an “art” rather than a science
- Relevant art factors
  - Reputation of team
  - Hotness of industry (hype cycles)
  - Customer traction
  - Revenues / revenue potential (size AND speed matters)
  - IP protection
  - Exit opportunities

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At which valuation: What is the right “price”? (5/5)

Series A and later stage valuation

- Multiple (or comparable) method: Which multiples apply in comparable companies with regard to KPIs, e.g. revenue or earnings
- Many VCs, however, will argue that even at this stage, valuation remains an art…

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Concluding (Personal) Observations

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Raising Outside Capital: Personal Observations

- **The venture market in Europe is maturing (but still way behind the US)**
  - Finding money for startups has become easier over the years, at least for early-stage financings
  - Angels and founders undergo a "professionalization phase" (backed by increasing serial entrepreneurs)
  - VC (and CVC) activity is generally increasing
  - Politicians discover the "sexiness" of the world of startups

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Raising Outside Capital: Personal Observations

- **Seed-stage financings**
  - Too many angels can mess up the cap table and thus make VC-backed rounds more challenging
  - Smart money is slowly growing
  - Convertible loans in seed-stage phase are gaining popularity
  - Angels start requesting VC-like investment protection

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Raising Outside Capital: Personal Observations

- **Early-stage/growth phase**
  - Non participating liq prefs are clearly the norm (so is the weighted average-ratchet for anti-dilution)
  - VCs have become more careful in investing

- **Is there a bubble?**
  - No quick answer possible…

- **How much fun is it to be a startup lawyer?** 👍💪😎

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Thank you !

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